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# CONSIDERATION OF GLOBAL TRENDS AND ISSUES, INCLUDING FOREIGN INVESTORS' MOTIVATIONS

## Foreign direct investment in developing countries: Recent trends and policy issues

Report by the UNCTAD secretariat

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**Summary and conclusions**

(i) Globalization of the world economy is best illustrated by the spectacular growth of foreign direct investment (FDI) during the second half of the 1980s. The global stock of FDI more than tripled over the past decade. The conjunction of many factors - deregulation, liberalization of financial markets, trade and FDI regimes, progress in communications, rapid pace of mergers and acquisitions and of technological innovations - contributed to spread economic activities beyond national boundaries. The early 1990s, however, witnessed a major downturn in global FDI flows, linked to continued economic uncertainty in developed countries.

(ii) Since the mid-1980s, the rate of growth of FDI flows to developing countries has steadily increased, following a modest expansion in the first half of the 1980s in the aftermath of the debt crisis. In the early 1990s, developing countries experienced a large increase in FDI, driven by the resurgence of growth in several Latin American countries, continuing strong growth performance in South and South-East Asia, and the steady trend towards privatization and liberalization of FDI regimes in all developing regions. As a result, developing countries' share of global FDI had risen to 25 per cent by 1991, signalling a return to earlier levels.

(iii) The distribution of FDI inflows among developing countries continues to show a high concentration in a small number of countries. In a world of internationalization of production through FDI, which is changing the dynamic comparative advantage of host countries and affecting their growth in a significant way, countries that are not included in this FDI-led globalization process run the risk of economic marginalization. In the medium term, as the incentive provided by high trade barriers becomes less relevant, FDI flows could be even more concentrated in countries endowed with large growing markets.

(iv) The location of FDI results from the interaction of three sets of factors. First, the decision to invest abroad derives from the global strategies of the transnational corporations (TNCs), which geographically allocate their activities according to market opportunities, technological requirements and rationalization of their production process. The recent technological progress and changes in industrial organization have shifted emphasis from factor costs (especially unskilled labour costs) to market considerations and availability of skilled labour as the driving forces behind the decision to undertake FDI. Second, once the decision to invest abroad is taken, the level of development, growth prospects and market size of potential host countries are important determinants in the location of FDI. Third, host country policies are factors which shape the profitability of investment by reducing or increasing the risks and uncertainty that might affect production and the return of investment, and by providing direct support to or hindering foreign investors' activities.

(v) For host countries, the policy agenda for increasing FDI inflows and for drawing maximum benefits from them includes the following priorities: ensuring a stable economic environment conducive to sustained growth; encouraging the development and upgrading of local industrial and technological capacities; and strengthening infrastructure and human resource development.

(vi) FDI could help to accelerate technological upgrading and industrialization, but cannot be the only engine for growth and industrialization. A thriving local industrial sector is, on the one hand, a factor which attracts FDI and, on the other hand, a conduit for technology transfer to host countries.

(vii) FDI based on high technology and skilled labour will benefit only a small number of advanced developing countries in the medium term. However, many industrial branches, especially those producing standardized manufactured goods, still require labour-intensive and low-technology inputs. FDI in these sectors, although globally less important, will remain significant for a large majority of developing countries. Furthermore, the descaling at the plant level in many sectors opens up new possibilities for locating production in smaller developing countries.

(viii) For poorer countries which lack the capacity to undertake comprehensive efforts to develop local capacities, there is an urgent need for more active support by the donor community in such areas as strengthening the private sector and local entrepreneurship, building institutional capacity, developing and improving physical infrastructure, and enhancing human resource development.

(ix) At the regional level, since FDI has increasingly become market driven, host countries would increase their locational attraction if closer linkages with neighbouring economies are established in order to generate larger markets and complementary locational advantages.

(x) At the international level, competition among host countries to attract FDI has led to an investment tussle, which in the end could be very costly for competing countries. These countries get trapped in the "prisoner's dilemma", which leads to competitive bidding in which all participants are left worse off than if no bidding had taken place. A first step towards reducing unnecessary costs would be to ensure more transparency on FDI policies. Countries could exchange information about their regulatory regime and other FDI-related policies, as well as the impact of these policies on FDI flows, with a view to sharing experiences on the costs and benefits arising from these policies. This exchange of information could eventually lead to the harmonization of incentive policies. From the perspective of TNCs, increased transparency of investment policies would enable them to make better FDI decisions in an overall improved policy environment for their international activities.

(xi) At the same time, the globalization of production increases the economic power of a few large TNCs. The evolving oligopolistic character of world production, reinforced by the growth of networks and strategic alliances extending beyond national borders, might serve to limit competition among firms but would increase rivalry among developing countries. This could weaken the capacity of many developing countries to negotiate successfully with TNCs. This also raises the question of how to maintain competition between firms increasingly linked through networks and alliances.

# I. Salient features of recent foreign direct investment (FDI) trends

## A. Growth of worldwide FDI flows

1. The period 1986-1990 witnessed an unprecedented expansion in worldwide FDI outflows. Their annual rate of growth averaged 28 per cent in current dollars 1/ or 18 per cent in real terms 2/ (table 1). By 1990, global outflows had reached $234 billion, or about four times the average level registered during the decade 1975-1984. As a result, the global stock of FDI more than tripled from about $500 billion in 1980 to $1.7 trillion in 1990.

2. In contrast to the boom years of the late 1980s, the early 1990s recorded the first major downturn in global FDI outflows since 1982. In 1990, global FDI outflows grew at 10 per cent in current dollars, but declined by 1 per cent in real terms; they then fell by 26 per cent in real terms in 1991 as a result of continued economic uncertainty in developed countries. However, preliminary data for 1992 indicate that the rate of decline has bottomed out (table 2).

## B. FDI trends in developing countries

3. Throughout the 1980s and early 1990s, the rate of growth of FDI inflows to developing countries has steadily increased. During the first half of the 1980s, FDI inflows to developing countries grew only modestly, hampered by the weight of the debt crisis (table 1). In the period 1986-1990 inflows grew at an annual average rate of 21 per cent in current dollars (or 12 per cent in real terms), encouraged not only by improved macroeconomic conditions but also by the liberalization of foreign investment regimes and the introduction of specific measures such as debt-equity swaps and privatization programmes in many developing countries. FDI inflows to developing countries increased by 21 per cent in 1991 (to US$ 36 billion), and by about 11 per cent in 1992 (to some US$ 40 billion) due in large part to a substantial increase in reinvested earnings. 3/

4. During the period 1986-1990, developing countries received only 17 per cent of worldwide FDI inflows. By comparison, their share stood at 25 per cent during the 1980-1985 period (table 3). As a result of the recent upsurge in inflows coinciding with a sharp fall in global flows, the developing countries' share jumped to 25 per cent in 1991 signalling a return to earlier levels. This new dynamism was led by the recovery in several Latin American countries and continuing strong growth performance in South and South-East Asia. Since 1987, FDI has become an important component of external resource flows to developing countries, rising from a trough of just over 17 per cent in 1987 to about 26 per cent in 1991. 4/

Table 1

Inflows and outflows of foreign direct investment, 1986-1991

| Country | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 | 1980-1985 | 1986-1990 | 1991 | 1980-1985 | 1986-1990 | 1991 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | (Billions of dollars) | | | | | | Share in world total (%) | | | Growth rate (%) | | |
| Developed countries | | | | | | | | | | | | |
| Inflows | 64 | 108 | 129 | 165 | 172 | 108 | 75 | 83 | 74 | -3 | 28 | -37 |
| Outflows | 86 | 132 | 162 | 203 | 226 | 174 | 98 | 97 | 97 | -2 | 27 | -23 |
| Developing countries | | | | | | | | | | | | |
| Inflows | 14 | 25 | 30 | 28 | 30 | 36 | 25 | 17 | 25 | 4 | 21 | 21 |
| Outflows | 2 | 2 | 6 | 10 | 8 | 5 | 2 | 3 | 3 | 1 | 41 | -35 |
| All countries | | | | | | | | | | | | |
| Inflows | 78 | 133 | 159 | 193 | 202 | 147 | 100 | 100 | 100 | -1 | 27 | -27 |
| Outflows | 88 | 135 | 168 | 213 | 234 | 180 | 100 | 100 | 100 | -2 | 28 | -23 |

Source: United Nations, World Investment Report 1992 (ST/CTC/130), United Nations publication, Sales No. E.92.II.A.19, and 1993 (forthcoming).

Table 2

Outflows of FDI from five major home countries, 1986-1992

| Country | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 | 1992a/ | 1980-1985 | 1986-1990 | 1991 | 1980-1985 | 1986-1990 | 1991 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | (Billions of dollars) | | | | | | | Share in world total (%) | | | Growth rate (%) | | |
| France | 5 | 9 | 14 | 19 | 35 | 24 | 14 | 6 | 10 | 13 | -6 | 63 | -31 |
| Germany | 10 | 9 | 13 | 18 | 28 | 21 | 16 | 8 | 9 | 12 | 4 | 29 | -24 |
| Japan | 15 | 20 | 34 | 44 | 48 | 31 | 16 | 10 | 19 | 17 | 22 | 34 | -36 |
| United Kingdom | 18 | 31 | 37 | 36 | 18 | 19 | 16 | 20 | 17 | 11 | -1 | 0 | 7 |
| United States | 14 | 26 | 14 | 26 | 29 | 29 | 50 | 26 | 13 | 16 | -16 | 20 | -0.4 |
| Total b/ | 61 | 95 | 112 | 143 | 158 | 124 | 112 | 69 | 68 | 69 | -5 | 27 | -21 |

Source: United Nations, World Investment Report 1992, and 1993 (forthcoming).

a/ Preliminary estimates.

b/ Totals may not add up due to rounding.

Table 3

Inflows of foreign direct investment to developing countries/territories, 1980-1991

| Country/territory | 1980-1985 | 1986-1990 | 1991 | 1980-1985 | 1986-1990 | 1991 | 1991 |
|---|---|---|---|---|---|---|---|
| | Average (billions of dollars) | | | Share in total (%) | | | Growth rate (%) |
| All countries | 50 | 150 | 147 | 100 | 100 | 100 | -27 |
| Developing countries | 13 | 26 | 36 | 25 | 17 | 25 | 21 |
| Africa | 1 | 3 | 3 | 3 | 2 | 2 | 45 |
| East, South and South- East Asia | 5 | 14 | 19 | 9 | 9 | 13 | 12 |
| Latin America and the Caribbean | 6 | 9 | 13 | 12 | 6 | 9 | 36 |
| Least developed countries | 0.2 | 0.2 | 0.2 | 0.4 | 0.1 | 0.1 | 12 |
| 10 largest host developing economies | 9a/ | 17b/ | 24c/ | 18a/ | 11b/ | 16c/ | 28c/ |

Source: United Nations, World Investment Report 1992,and 1993 (forthcoming).

a/ Argentina, Brazil, China, Colombia, Egypt, Hong Kong, Malaysia, Mexico, Nigeria, Singapore.

b/ Argentina, Brazil, China, Egypt, Hong Kong, Nigeria, Singapore, Taiwan, Province of China, and Thailand.

c/ Argentina, Brazil, China, Indonesia, Rep. of Korea, Malaysia, Mexico, Taiwan, Province of China, Thailand and Venezuela.

5. As a result of the debt crisis, Latin America's share of worldwide FDI fell from 12 per cent in 1980-1985 to 6 per cent in 1986-1990, though a small number of countries, notably Argentina, Chile and Mexico, managed to increase their volume of FDI inflows since the late 1980s. 5/ More recently, stronger growth in several Latin American countries, major improvements in macroeconomic performance, the relaxation of foreign investment policies and privatization initiatives helped to improve the region's attractiveness to foreign investors. New inflows underwent a considerable expansion in 1991 (by 36 per cent to US$ 13 billion), which appears to have been sustained in 1992. Debt-equity swaps and privatization of State enterprises were responsible for much of the new inflows; consequently a large part of these inflows have gone into the acquisition of existing assets rather than to greenfield investment. In spite of these improvements, FDI inflows in Latin America were still concentrated in a small number of countries (Argentina, Brazil, Chile, Mexico and, recently, Venezuela).

6. During the 1980s, Africa's tiny share of global FDI flows declined even further, from 3 per cent in 1980-1985 to 2 per cent in 1986-1990, with the region's least developed countries experiencing extreme marginalization. However, in 1991 inflows reached US$ 3 billion, an increase of 45 per cent over 1990. Three quarters of these flows were attracted by oil-exporting countries. The attractiveness of many non-oil-producing African countries to foreign investors continues to be overshadowed by slow economic growth and unstable domestic conditions, negating the positive steps taken to liberalize the regulatory framework of FDI. Nevertheless, Africa's rich natural resources should provide the basis for a renewal of investment in the near future.

7. On the upside, East, South and South-East Asian countries are now among the leading recipients of FDI flows. Their share of global inflows averaged 9 per cent throughout the 1980s; in 1991, it reached 13 per cent, which was the highest share among regional groups of developing country recipients (table 2). Asia continued to account for more than half of all FDI flows to developing countries. The bulk of these flows went to a few countries: China, Indonesia, Malaysia and Thailand. China has now emerged as the largest single recipient of FDI flows in the region (and indeed among all developing countries). The attractiveness of these countries is based on their high economic growth rates, favourable domestic conditions and relatively low labour costs. The size of the Chinese, Indian and Indonesian domestic markets is an additional asset. Recent moves in India towards liberalization of its FDI regime coupled with lower production costs have resulted in a significant increase in investment flows in 1991 and 1992.

8. As the Asian FDI market expands, there is a tendency for countries to seek to improve the quality of their inflows by strengthening domestic linkages and encouraging investment in technologically-advanced industries. The availability of skilled labour and low production costs have encouraged foreign investors to use the region as a production base from which to supply markets worldwide. At the same time, lower-skilled labour-intensive industries have tended to move from the technologically more advanced and higher cost locations, (such as Taiwan, Province of China, Singapore and the Republic of Korea) to low-cost Asian countries. This has given rise to an

increasingly dynamic intraregional network of investment and trade especially between Hong Kong, Malaysia, Singapore, Taiwan, Province of China and Thailand.

9. In Central and Eastern Europe, the expansion in FDI inflows, which started in 1990, continued in 1991 and during the first half of 1992, though the volume remained small (US$ 2.4 billion in 1991). Privatizations and other market-oriented reforms have helped to encourage FDI in that region. Nevertheless, the prospects for a sustained expansion of FDI remain uncertain due to the unsettled economic and political environment.

10. While the regional dominance of FDI flows to developing countries continues to be strongly in favour of Asia, the concentration of these flows among individual country recipients has recently weakened. Though the 10 largest developing country recipients of FDI remain well entrenched, they now account for a smaller proportion of total inflows to developing countries than in the early 1980s (66 per cent in 1991 compared to an average of 71 per cent for the period 1980-1985). The number of developing countries attracting significant inflows of FDI has increased substantially. It appears that a second group of developing countries is rapidly emerging as a major pole of attraction for FDI. 6/

## C. Origin and sectoral destination

11. Recent FDI patterns have displayed notable changes in the sources of these flows and their sectoral concentration. Virtually all FDI flows (97 per cent) originate in OECD countries. France, Germany, Japan, the United Kingdom and the United States accounted for about 70 per cent of global FDI outflows during the 1980s. However, flows of FDI from Japan have undergone a remarkable expansion (from 10 per cent of world outflows in 1980-1985 to 20 per cent in 1986-1990), making Japan the world's largest source of FDI. The growth of FDI from France has also been quite impressive (from 6 per cent to 10 per cent of worldwide flows during the same period). The recent gains made by French and Japanese FDI have replaced declining flows from the United States and the United Kingdom (whose shares have fallen from 26 per cent to 14 per cent and from 20 per cent to 17 per cent respectively) (table 2).

12. The main suppliers of FDI to Latin America remain the United States (56 per cent in 1988-1989) and Europe (23 per cent). In Asia, Japan has emerged as the predominant partner, strengthening its position from about 28 per cent in the period 1980-1984 to about 57 per cent in 1988-1989 (the United States and European investors provided about 26 per cent and 17 per cent respectively in 1988-1989). FDI from the United States to Africa has virtually disappeared, accounting for only 3 per cent of that region's inflows, whereas Europe and Japan supplied 71 per cent and 44 per cent respectively of FDI flows to Africa during 1988-1989. The dominant role of FDI from the United States in Latin America and the Caribbean, from Japan in Asia, and from Europe in Africa, underlines the tendency towards greater regionalization of FDI around the three main home centres. This pattern was most pronounced towards the end of the 1980s and partly reflected the strategies followed by transnational corporations (TNCs) from the "Triad" in building up regionally integrated networks of affiliates.

13. The distribution of worldwide FDI flows by economic sectors shows the preponderance of the services sector, most noticeably in the cases of flows from Japan and France. But there were also substantial new inflows of FDI into the secondary sector (mainly manufacturing). Sectoral distribution appears to have differed among regions and countries according to their level of development. In most countries in Asia, FDI went primarily to the secondary sector, although investment in the tertiary sector was of major importance for many Asian countries. Some resource-rich countries like Indonesia, Papua New Guinea and Viet Nam also attracted FDI into the primary sector (mainly oil production). In Latin America, the rate of new investment flows into the natural resources and services sectors has now surpassed that in the manufacturing sector. In Africa, the bulk of FDI went to the primary sector.

## II. Foreign investors' motivations

### A. Factors leading to the internationalization of production

14. The reasons that push enterprises to extend the horizon of their activities beyond the boundaries of their home base or to expand their international operations can be grouped in six broad types: 7/

(1) Market-expansion motive. This is linked to the horizontal integration strategy of firms. Production will move to fast-growing markets, to protected markets (as a means to overcome trade barriers), and to countries with preferential access to other large markets.

(2) Cost-reduction motive. This often leads to investment in locations where labour costs are low. This motive is particularly relevant in the low-technology segments and assembly plants, which do not require highly skilled labour and for which labour represents an important element of production costs. Foreign production locations then become platforms for exporting finished or intermediate products to other markets.

(3) Resource-seeking motive. Firms invest to secure sources of primary commodities and integrate them vertically in their production process. Primary resources can also be exploited for exports to other countries.

(4) Technology-seeking motive. It induces a firm to invest abroad, with a view to gaining access to foreign technology. This motive seems to be very often at the basis of the decision by firms from developing countries to invest in developed countries. Technology-seeking enterprises may acquire foreign companies to secure access to some technology that foreign firms control. Alternatively, they may establish research or production facilities in a foreign country to take advantage of available trained personnel or to acquire experience in product development and marketing.

(5) Risk-avoidance motive. Concerns about risk avoidance lead to the decision to diversify centres of production geographically, in order to minimize exchange rate risks, to achieve more stable overall demand by operating in diversified markets, or to dilute the political risk linked to investment in one country.

(6) Defensive competitive strategy. This is an important factor which explains the growth of cross-investments between industrialized countries. This motive seems to have gained importance since 1980.

15. With these motives in mind, firms need to have other specific characteristics that offer an advantage or support for the internationalization of production. These characteristics are the following:

- the size of the firm, which allows economies of scale or economies of scope: 8/ a positive correlation exists between the firm's size and its internationalization. However, this characteristic is not the most important, as small and medium-sized enterprises (SMEs) have also "gone international". Very often, these SMEs follow the big international firms abroad as their suppliers. The main sectors where the presence of multinational SMEs is important are: mechanical engineering, metallurgy, chemicals and electrical machinery. Internationalization of SMEs often takes the form of joint ventures, or joint production without equity participation. Nevertheless, despite the participation of thousands of SMEs in the internationalization of production, the largest companies still account for a significant share of TNCs' foreign assets; 9/

- the importance and high potential of research and development (R & D) activities: firms engaging in intensive R & D activities acquire a technological advantage over their competitors; the more sophisticated this technological advantage is, the more firms will be willing to exploit it by producing themselves rather than licensing;

- a production line that allows for product differentiation to respond to specificities of different consumer markets;

- easy access to finance, which allows for a large financing of investment abroad. It is sometimes argued that firms tend to invest abroad when accumulated profits are high (the case of United States firms in the 1960s and Japanese firms in the 1980s). In some instances, producing firms belong to a holding dominated by a bank or a banking consortium, which provides the financial backing for foreign operations. The recent globalization of financial markets has provided TNCs with broader means to finance their operations worldwide;

- export experience: almost without exception, before undertaking foreign direct investment TNCs have had long experience in exporting to foreign markets, thus accumulating a good knowledge of the global market.

16. Finally, the distribution of FDI worldwide results from the interaction between TNCs' motivations and the advantages of foreign locations 10/ (reflected in such factors as level of development, growth prospects, and quality of infrastructure and human capital).

## B. Traditional determinants of FDI in developing countries

17. Traditionally, FDI in developing countries has been of two types: local-market-based or export-based. In the first type, FDI is geared towards local or regional markets because of protective trade barriers, or to exploit markets with high growth potential, or else to provide support facilities, such as trading houses, in the markets that are served through exports from home bases. FDI of the second type exploits a comparative advantage of host countries in order to develop a platform for exporting to the international market. This comparative advantage may be derived from a rich resource base, a cheap labour force or preferential access to other markets. The importance of each of these factors has varied over time and with the sectoral activity concerned.

18. In the 1960s and 1970s, much of FDI in Latin America went into import-substituting ventures, to overcome the high protective barriers of countries in this region and also to establish production units to supply the regional markets created by regional integration agreements. In the 1970s, FDI in Asia was attracted by low labour costs. Singapore and Hong Kong, with their policies of openness to FDI and availability of a numerous and cheap labour force, were the first locations for production units of TNCs in their vertical integration strategy, thus serving as export platforms to other countries (including home countries). In Africa and the Middle East, FDI was mainly concentrated in the exploitation of primary resources.

19. In the 1970s and early 1980s, foreign investors relocated in developing countries the production of primarily labour-intensive goods requiring only simple production technologies, very often using these locations as assembly lines for intermediate products which were then re-exported to the home countries.

20. In the manufacturing sector, FDI in developing countries is concentrated in fewer industries than in developed countries. This low dispersion of industrial investment results from the less advanced level of development, but also from restrictive policies in the past which barred entry to some reserved sectors. There is no typical pattern of industrial distribution as differences exist among countries according to their resource endowment, level of development and policy priorities. However, the evidence available from country case studies suggests that chemicals, electronics, textiles and food processing are among the branches that have received the largest amounts of FDI. 11/

21. FDI based on the exploitation of cheap unskilled labour in developing countries was made possible by the mass production of standardized goods, which allowed for vertical integration involving a clear division of labour, between highly skilled and low-skilled tasks, and the separation of conception from execution. However, cheap unskilled labour represents a fleeting source of comparative advantage for host countries. As income levels rise, labour costs will also increase, and other host countries will become comparatively more attractive in terms of labour costs. FDI will therefore shift from the "first generation" host countries, where income levels have increased, to "second generation" host countries. The "first generation" countries will consequently have to implement policies to upgrade their technological

capacity in order to attract more FDI with a higher technological content and/or to invest themselves in other developing countries where labour is still cheap.

22. In recent years, technological progress and innovations in industrial organization have considerably diminished the importance of cheap labour in industrial production. The outcome of these developments is a new reallocation of FDI. It is becoming clear that FDI based on large-scale requirements for comparatively unskilled manpower for repetitive tasks will recede in favour of FDI requiring high-tech infrastructure and skilled labour. For example, the United States has been relocating increasingly high-tech production (such as electrical and electronic machinery) to the NICs and the ASEAN countries, despite the fact that wage rates in NICs have increased and are relatively higher than in other developing countries. 12/ Another example is India, where many computer companies have relocated their software units to take advantage of the availability of highly skilled and relatively low-cost scientists and engineers. 13/

23. FDI based on high technology and skilled labour will benefit only a small number of advanced developing countries in the medium term. Many industrial branches, especially those producing standardized manufactured goods (such as simple consumer electronics, garments for export markets or processed foods) still require labour-intensive and low-technology inputs. FDI in these sectors, although globally less important, will remain significant for a large majority of developing countries.

### C. Globalization, technological progress and their impact on FDI

#### 1. Globalization

24. As a result of the rapid reduction in transportation costs, and the revolution in communications and information technology, as well as the liberalization of cross-border movements of capital, goods and services, enterprises have globalized their activities in order to strengthen their competitive position.

25. By the mid-1980s, globalization had become a general tendency, originating in the financial sector and later spreading to the industrial sector. The globalization of financial markets came in the wake of the generalized deregulation of domestic financial markets, the virtual elimination of barriers to the movements of capital between industrialized countries, and the impressive development of a worldwide communications system. This globalization led to the multiplication of offshore financial centres and to the introduction of a wide range of new financial instruments. Through this process, international banks have substantially increased their capacity to mobilize finance and to respond effectively to the financing of global strategies of TNCs by enlarging access to finance in any point of the world and by offering a choice of financial instruments adapted to the needs of global firms.

26. In the industrial sector, especially in the high technology segments, global competition has also become a normal feature. Trade liberalization and industrial deregulation have opened previously protected economic sectors to

international competition. Rapid technological progress forces firms to enlarge markets to amortize R & D costs. Changes in consumer markets require product differentiation and physical presence on these markets to respond quickly to shifts in demand.

27. Global strategies of firms focusing on market considerations can be defensive, to retain market shares, or offensive, to increase market shares. 14/ TNCs employ an integrated worldwide approach by locating activities in many countries and coordinating them actively by a combination of trade and FDI strategies (including strategic alliances).

2. Technological progress and new industrial organization

28. The phenomenal advance of technological innovations, in particular in the areas of electronics and robotics, has had a significant impact on relative factor costs, skill requirements and logistical arrangements in the manufacturing activities of industrialized countries. These developments are most noticeable in the sectors of semiconductors, electronic and automotive components, and consumer electronics. Furthermore, these technological innovations have brought about important changes in the production process:

- Labour productivity has improved in industrial countries to the point that direct labour is becoming a minor part of total production costs. Technical sophistication in the manufacturing process has made manufacturing more capital intensive and requires more skilled labour in both production jobs and white-collar occupations.

- Product design and manufacturing techniques have become more interlinked. This interaction has been facilitated by new technology, particularly computer-assisted design techniques. In addition, product design today encourages the use of new materials which serve as substitutes for more traditional materials, especially metals. This process requires continuous efforts in R & D in order to adapt production to market demands.

- The new industrial organization, facilitated by computer technology, takes the form of "just-in-time" systems, whereby locational proximity and integration of supplier and customer plants reduce the costs of maintaining stocks of raw materials, work-in-process and even finished inventories.

29. This new pattern of production, variously referred to as "post-fordism", "flexible specialization", or "the new competition" has changed the basis of global competition from price to product innovation and differentiation. To be sure, cost minimization remains the concern of producing firms, but the primary tool to gain competitive advantage is product innovation. This pattern has condemned "fordist" industrial organization based on mass production, standardization and large-scale plants. 15/ The new product flexibility requires a descaling of plants and shortening of production runs, which, however, do not lead to the downscaling of the size of the global enterprise. On the contrary, large TNCs have benefitted from economies of scope through an integrated coordination of their different affiliates,

**Box 1**

**Networking and strategic alliances**

There are three primary motives fuelling the expansion of networking and the building of strategic alliances among global firms. The first is the survival motive. This recognizes that strategic alliances are inherently against the nature of firms to compete with one another. However, in order to survive, firms must interact to obtain the resources they need. Interactions are coordinated not through the market but by the establishment of a series of relationships among the members of the network.

The second and third motives are interrelated and are technology and efficiency driven. Increasing product complexity (the technology motive) creates a situation in which no single firm masters the entire production cycle. Rather, globalization pushes companies to concentrate on their main lines of activity, to shed unrelated production lines, and to acquire components and services from more efficient partners (the efficiency motive).

A firm's decision to "make or buy" will be influenced by the nature of the network in which it participates. This varies from the formal contractual arrangement (the Western style), to the relationship based on trust, honour and the safeguarding of reputation (the Japanese style), in which members believe that they can best advance their own interests by furthering the interest of the group.

Whatever the basis, networking and strategic alliances by both Japanese and Western TNCs have ballooned in recent years, especially within the electronics, information technology and aerospace industries where product complexity and the sharing of capital risk and R & D costs are very important.

Questions have arisen about the solidity of the organizational structures to which the rapid increase in cross-border alliances has given rise. Two alternatives have emerged: the "virtual firm", i.e. a temporary network of companies formed to exploit a specific market opportunity which lies beyond the technological reach of any one of them; and the "relationship-enterprise", i.e. a network of longer-term strategic alliances among big companies, spanning different industries and countries, and acting as if they were a common entity. 16/ The "relationship-enterprise", it is argued, is driven not only by technological change but also by the political necessity of having multiple home bases.

Networking and strategic alliances do not mean the end of competition. A more likely outcome is the intermediate situation in which firms perform a dual role: cooperation at the group level, and competition in the supply of finished products and end-use services and the demand for factor inputs.

and from spreading expenditures on R & D over a greatly expanded sales base. The new flexibility also makes room for innovative networking relationships among SMEs.

30. The globalization process of TNCs has introduced new global structures which differ from the simple organizational structures based on the horizontal or vertical diversification process. The new global firm disperses and coordinates its activities through a complex organizational structure, relying at the same time on a network of non-equity arrangements with its suppliers and subcontractors and strategic alliances with its competitors. Following its global strategy, a firm can choose any nation in which to assemble products, fabricate components or even conduct research, wherever advantages are to be found. Markets are often coordinated on a regional basis.

### 3. Impact on FDI patterns and policies

31. Globalization and technological progress have far-reaching implications on the rate of growth and locational patterns of FDI. First, FDI is expected to expand further. To sustain competitive advantage, firms have to adopt global strategies, which involve an integrated approach that takes into account all relevant trade and foreign direct investment considerations. At the same time, the new product flexibility often requires the relocation of production units in the consumer markets in order to enhance the ability to tailor products to national demand specificities. These two factors are likely to lead to an intensification of FDI, involving large TNCs as well as SMEs.

32. Secondly, technological innovations give rise to manufacturing techniques that tend to be both capital and skill intensive, and to reduce the labour content of production. Furthermore, close ties need to be maintained between equipment makers, producers and customers. These considerations reduce the possibilities for locating production facilities in developing countries to serve customers in developed countries. As developed countries, on the one hand, offer large sophisticated consumer markets and, on the other hand, are well endowed with skilled human resources, it is possible that many production units of TNCs will be relocated back in those countries. 17/

33. However, as pointed out earlier, some industries, especially those producing standardized consumer goods and those with a lower technology content, still rely on price competitiveness and, hence, minimization of labour costs. These industries will continue to take advantage of cheap labour costs in developing countries.

34. At the same time, some developing markets, either national or regional, offer good prospects because of their large size or growth potential. FDI in medium-technology sectors would tend to flow into these countries; in so doing, TNCs would also transfer new industrial organization patterns to developing country markets, as they would insist that their suppliers (often SMEs) also establish local factories to serve them in production destined ultimately for the local or regional markets. Furthermore, the descaling at the plant level in many sectors opens up new possibilities for locating production in smaller developing countries.

35. In addition, some developing countries have upgraded their technological capacity and the technological skills of their labour force. TNCs will be interested in locating some of their high-technology activities in these countries, as export bases.

36. Overall, therefore, technological and organizational innovations in high-technology industrial sectors will drive FDI in these sectors into countries at an intermediate level of development with a well trained and skilled workforce, in poorer countries with fairly high educational standards, or countries that represent either actually or potentially large and growing markets with pools of skilled workers. This points to the overriding importance for developing countries to invest in the development of their human resources, infrastructure and producer services. It also highlights the danger of marginalization of low-income countries with a low level of skilled labour.

37. The new globalization process also has an important impact on national policies and arouses concerns in the area of competition. A few large TNCs may hold a large part of the decision-making power over the international distribution of industrial production as well as over the development of and access to new technology. The intensified process of globalization leading to ever larger corporate conglomerates raises the risk of industrial cartelization. The oligopolistic character of the world economy might serve to limit competition among firms but would heighten the rivalry among developing countries to attract FDI. This could weaken the capacity of many developing countries to negotiate successfully with TNCs. Moreover, the growth of multi-firm, global strategic alliances increases the possibility of a decline in the bargaining power of individual countries vis-à-vis firms whose boundaries extend beyond national borders. It also raises the question of how to maintain competition between firms increasingly linked through networks and alliances.

## III. Competitive advantage of host countries

### A. Dynamic development pattern and FDI

38. Once the decision to invest abroad is taken, the choice of where to locate production facilities will depend on the level of development, resource endowment (including labour force) and government policies of host countries.

39. The level of development is an important determinant for FDI location. Host countries attract different types of FDI with differing technological contents that are compatible with their level of development. Countries can be classified according to four stages of development: (1) factor-driven, (2) investment-driven, (3) innovation-driven, and (4) wealth-driven. 18/

(1) The factor-driven stage is characterized by production using basic factors, either natural resources or an abundant and inexpensive semi-skilled labour pool. The range of industries is limited and is concentrated in the price-competitive segments, requiring either little product or process technology or inexpensive technology that is widely available. Technology is sourced largely from other nations. Most developing countries are at this

stage, although there are differences between countries relying on natural resources and countries with embryonic industrialization based on cheap unskilled labour.

(2) The investment-driven stage involves the use of more sophisticated technology in industries. Firms invest in modern, efficient and often large-scale facilities equipped with the best technology available. Production in the relatively standardized, price-sensitive industries is still important. However, the range of industries is broader and uses increasingly skilled workers who are still paid relatively low wages. Foreign technology and methods are not just applied but improved upon. At this stage, countries have additional competitive advantage in the manufacturing of intermediate and capital goods (heavy and chemical industries) and infrastructure (housing, transportation, communications and public works). The newly industrialized countries (NICs) have reached this stage.

(3) The innovation-driven stage brings a widening of industries and segments in which a country can successfully compete. This stage is characterized by an abundance of skilled human capital and an intensification of activities in R & D. The price-sensitive, less sophisticated segments are gradually ceded to firms from other nations, while countries at this stage enjoy a growing international position in more differentiated industry segments and sophisticated services. Firms continue to compete on costs, not so much on factor costs as on productivity due to high skill levels and advanced technology. The advanced, industrialized countries have reached this stage.

(4) The wealth-driven stage ultimately leads to decline, because reliance on accumulated wealth makes national industries less competitive, and chronic underinvestment in industry results in a slowing of innovation.

40. The industrialization process of countries has tended to follow this dynamic pattern, although countries do not necessarily reach the final decline if efforts are made to sustain investment in industries. In the course of their structural transformation, countries will attract the type of FDI which is compatible with their stage of development. 19/ For example, the beginning of the factor-driven stage attracts resource-seeking - or labour-intensive-FDI. At the investment-driven stage, countries attract investment in capital and intermediate goods industries; at the same time, these countries begin to invest abroad, in other lower-wage countries, in labour-intensive manufacturing and resource extraction (particularly if the economy happens to be scarce in natural resources). At the innovation-driven stage, countries attract investment in technology-intensive industries, but also make outward investment in these industries and in other less sophisticated segments.

41. At successive stages of development, FDI can help to accelerate structural change by raising national income and savings, by upgrading technology and by providing externalities through access to services, management and networking capacities. However, the role of domestic policies in upgrading productivity and technology is essential. With appropriate government policies to ensure an "enabling" investment climate, to upgrade

human resource development, to provide adequate physical infrastructure, and to encourage investment in technology, the industrialization process will move into higher value-added, more capital-intensive sectors.

42. With hindsight, it is clear that the process of development and technological transformation of Japan and the NICs has followed this dynamic pattern. With the exception of the NICs, developing countries find themselves at the first stage of development. The difficulties encountered by them in their attempts to move quickly to the second stage of development have resulted not only from domestic policy weaknesses but also from unfavourable external factors.

43. Present conditions of depressed world commodity prices and saturation in most markets for unsophisticated consumer manufactures, together with the unstable domestic economic environment, explain the fact that low-income countries, especially the resource-rich countries of Africa, are not attracting large FDI flows.

## B. FDI from developing countries

44. This dynamic pattern of development also explains the transformation of NICs from being exclusively recipients of FDI to becoming sources of investment in other developing countries. As rising levels of income raise wages and appreciate domestic currency, countries that have upgraded the technology content of their industries will locate the labour-intensive and less sophisticated segments of their industries in other countries at a lower stage of development. However, the relocation of low-technology industries in low-wage countries is not the only reason. Firms from dynamic developing countries may have the same global competition approach as the big TNCs. Motives for investing abroad can include market considerations as well as technology-seeking motives.

45. The most dynamic foreign investors from developing countries are the South-East Asian NICs (Republic of Korea, Singapore, Taiwan, Province of China), India and Brazil. Surveys of FDI from developing countries highlight some general features: 20/

(a) First, the geographical distribution favours neighbouring and/or ethnically related countries. Some TNCs from developing countries invest in developed countries either to gain access to export markets or to acquire particular skills and/or technologies.

(b) Second, FDI tends to concentrate in industries using mature or standardized technology and management skills or industries based on natural resources (mostly processing, textiles or mineral exploitation). These investments are sometimes preceded by, or associated with, those promoting exports from investing countries.

(c) Third, most TNCs from developing countries are confined to a limited number of foreign countries. Many prefer to be involved in joint ventures, both to limit their capital commitments and to obtain know-how, managerial and organizational skills or access to the markets of their foreign partners.

## IV. The role of host country policies

46. The risks and profitability of an investment in a foreign country depend to a large extent on the policies adopted by the host country. An appropriate policy framework is needed to promote a favourable climate for investment. Such a climate is characterized by political stability, as well as a stable, transparent and predictable economic and legal environment, which allows foreign investors to earn and repatriate reasonable returns on their investment and to integrate their local subsidiaries in their global strategy.

### A. Economic conditions

47. One of the most important economic factors in attracting FDI is the strength and growth of the host economies. 21/ Countries with poor growth prospects, even if they adopt a very liberal FDI regime, would not be considered as attractive investment locations. This also explains the slump in FDI in highly indebted countries in the 1980s, as the debt crisis and accompanying stagnation deterred FDI inflows.

48. The lessons of the 1980s have also highlighted the importance of macroeconomic stability in enhancing growth and promoting an "enabling" environment for investment. For domestic and foreign investors, the effects of host country economic conditions on the firms' costs are a central concern. Thus, inflation, the exchange rate, and interest rates are factors that have a direct impact on these costs. A stable macroeconomic policy framework would reduce the costs resulting from uncertainty about the fluctuations or adverse impact of the above-mentioned factors.

49. The general trend towards the application of market-based economic policies, (including privatization and trade liberalization), which are currently pursued by most developing countries and countries of Central and Eastern Europe, is having an impact on FDI flows. In 1990, more then 70 countries had active privatization programmes and the annual number of privatizations worldwide more than quintupled between 1985 and 1990 to around 130. 22/ By the end of the 1980s, the value of state enterprises sold was reported to have reached over $185 billion, with no sign of a slow-down. The participation of foreign companies in the privatization programme has been significant, particularly in Latin America and Central and Eastern Europe. Very often, privatization operations are integrated in debt-equity swaps programmes so as to avoid the potential inflationary impact of such swaps. However, privatization by itself will not be successful in encouraging significant new FDI inflows unless it is accompanied by an overall framework of appropriate policies to ensure a favourable climate for investment.

50. The trend towards the generalized adoption of more liberal, outward-oriented trade policies resulted mainly from the perception that inward-looking industrialization policies brought more costs than benefits. In particular, the experiences of import-substituting foreign investment, generally protected by high barriers from world competition, turned out to be quite inefficient in many cases, especially in the context of sagging domestic markets. Some exceptions exist, however, especially in the industrially advanced countries (Brazil and Mexico, for example), of import-substituting foreign ventures becoming major exporters when given adequate incentives,

access to competitive inputs, an appropriate support structure and the opportunity to reap economies of scale (e.g. the automobile industry). 23/

51. The general shift from protected, inward-oriented policies to more liberalized trade, whether induced by structural adjustment programmes or, more gradually, by governments on their own initiative, puts domestic industries increasingly in competition with imports. Consequently, the competition for attracting FDI could become fiercer, as countries would look to FDI as a means of strengthening the competitive stance of domestic industries. Over the medium term, as the incentive provided by high trade barriers becomes less relevant, FDI flows could be even more concentrated in countries endowed with large growing markets and better placed to take advantage of new technologies.

B. Infrastructure and human resources development

52. Foreign ventures cannot operate in isolation from the local business and industrial environment of host countries. Foreign and domestic investors need adequate private and public support facilities, including capital markets and credit facilities, and efficient physical, technological and human capital structures. It has been noted that the availability of such facilities is determinant. Economic or regulatory policy reforms cannot in themselves offset the obstacles to FDI that are inherent in the structural weakness of recipient countries. A few areas are of particular importance when dealing with FDI:

- As mentioned above, the availability of skilled labour is an important factor in FDI location. Active policies to upgrade human capital through the provision of a high, quality educational and training system are priorities on host governments' policy agendas. Furthermore, as illustrated by the experience of South-East Asian NICs, success in absorbing and efficiently deploying industrial technologies transferred by foreign firms greatly depends on efforts to develop local capabilities, particularly through skill upgrading and local R&D activities (which often require government intervention to overcome "market failures" in investment and education).

- Another determinant is the availability of high quality communications and transport systems as well as an energy supply and other utilities.

- The existence of a thriving locally-owned business sector creates a supportive environment for FDI through efficient networks of local suppliers, consultants, service firms, and possibly partners or competitors. Therefore, it would also be essential to concentrate efforts on the development of local entrepreneurship.

- Business activities should be able to rely on an efficient financial system that caters for the diversified needs of investors in terms of different term structure and risk-bearing loans.

- The provision of appropriate support facilities is a formidable task, involving large and costly investments in infrastructure, education, research and institution building. It is a slow, incremental process which requires good administrative capacity on the part of the government.

- In many countries, because of the high costs involved in building infrastructure and institutions, governments have concentrated their efforts on establishing export processing zones endowed with good support facilities as well as with tax concessions. 24/

- For poorer countries which lack the capacity to undertake comprehensive efforts to build local facilities, there is an urgent need for more active support by the donor community in such areas as strengthening the private sector and local entrepreneurship, building institutional capacity, developing and improving physical infrastructure, and enhancing human resource development.

## C. FDI-related policies and regulatory framework

### 1. Liberalization of FDI policies

53. The 1980s witnessed important changes in government policies on FDI. The unfolding of the debt crisis, the widening of the technological gap, as well as the shift towards export-oriented industrialization strategies, have changed developing countries' attitudes towards FDI. It is now generally recognized that FDI could play a valuable role in promoting growth and development.

54. Reflecting these changes, the worldwide trend towards liberalization of government policies on FDI, which started in the 1980s, accelerated in the early 1990s, especially with the recent implementation by Central and Eastern European countries of liberalized FDI regimes. 25/ In addition, several regional groupings such as the European Community (EC), Caribbean Community (CARICOM), Eastern and Southern Preferential Trade Area (PTA), Southern Cone Common Market (MERCOSUR), and the forthcoming North American Free Trade Agreement (NAFTA) contain investment regulations at the regional level, aiming at a more liberal stance on FDI. However, a few Western countries traditionally associated with liberal attitudes towards foreign investors introduced some controls on business operations affecting foreign investment, although, overall, the framework for FDI in all developed countries is now liberalized to a very large extent. The OECD member States have adopted the "Codes of Liberalization of Capital Movements and Current Invisible Transactions".

55. The new liberalizing measures adopted by developing countries have typically included the lifting of local ownership requirements and sectoral restrictions (for example, in services such as banking, tourism and telecommunications), the simplification of approval procedures, liberalized conditions of entry and establishment, and the introduction of more liberal rules for the transfer of funds and capital repatriation.

56. This trend does not mean, however, that the pace of change has been the same for all countries. Differences arise mainly from countries' strategies on, and success with, technology development. Countries that had made major progress in building up domestic capabilities, while becoming more attractive as an investment location, could afford to adopt liberalized FDI regimes. Some other countries, while welcoming FDI, restricted foreign entry in sectors reserved for indigenous technology development.

2. Bilateral treaties and World Bank guidelines

57. Over the past few years, the network of bilateral treaties for the promotion and protection of FDI continued to expand and reached a total of 440 by mid-1991. 26/ In an effort to promote a favourable climate for foreign investors, host countries concluded bilateral treaties which typically covered the following areas:

- treatment of foreign investment (generally including fair and equitable treatment, and most-favoured-nation treatment, but not right of establishment);

- expropriation (in the public interest, or for public purpose);

- compensation (prompt, adequate and effective, and determined by accepted criteria);

- transfer of payments (effective transfer of profits, wages and salaries, capital repatriation and compensation);

- subrogation and settlement of disputes.

58. In 1992, at the request of the Development Committee, the World Bank compiled a set of guidelines on the legal framework for the treatment of foreign investment, drawing on the general trends and provisions established by bilateral investment treaties, national investment codes and multilateral instruments. 27/ In the view of the World Bank, these guidelines represent a "desirable overall framework which embodies essential principles meant to promote foreign direct investment in the common interest of all members". The guidelines contain principles related to: (a) admission, (b) treatment (including the transfer of investment capital and returns), (c) expropriation and unilateral alterations or termination of contracts, and (d) settlement of disputes. As these guidelines provide a good indication of the state of the art in respect of the evolution of principles and standards related to the treatment of FDI, they represent a useful global instrument, giving a measure of principles and concepts that are acceptable to all States in relation to FDI from any other State.

3. Incentives and disincentives

59. In addition to national codes and bilateral treaties on foreign investment, many host countries applied special measures to provide incentives or to impose particular requirements vis-à-vis foreign investors. Incentives may include:

- fiscal measures (such as preferential tax rates, tax holidays, tax exemptions, tax credits, accelerated depreciation, other measures relating to social security contributions and investment reserves);

- financial measures (such as grants, preferential loans and loan guarantees);

- tariff concessions (tariff and non-tariff barriers on final goods produced by foreign investors, and tariff exemption on inputs);

- debt-equity swaps (benefits of debt discount accruing to foreign investors);

- export processing zones;

- other non-financial measures (such as infrastructure-related assistance, preferential government contracts, and provision of certain services).

60. The disincentives or performance requirements, which are generally referred to as trade-related investment measures (TRIMs) may include requirements on exports, local content, trade balancing, domestic sales, import substitution, local equity, and transfer of technology.

61. Disincentives are very often linked to the award of incentives. For example, the availability or level of a particular award may be conditional upon, or proportional to, the fulfilment of performance requirements. In this way, performance requirements are viewed as a means to reduce the costs of incentives for host countries.

62. The main objective of incentives is to influence foreign investors' decisions on the location of their investment, with a view to developing targeted industrial sectors, correcting regional imbalances within a country and reducing unemployment. Performance requirements are used for different purposes: to protect the domestic sector; to stimulate domestic activity through backward and forward linkages; to improve the integration of foreign-controlled enterprises into the host country economy; to secure host country benefits from FDI; and to counteract what some host countries perceive as practices of multinational enterprises that would reduce the scale of such benefits.

63. The theoretical justification for the use of incentives and disincentives can be based on the argument that under conditions of imperfect or oligopolistic competition among TNCs, it is legitimate for countries to play a more active role in shaping the composition of their economic base, notably by influencing the location of production, the selection of inputs, the size of operations and the marketing of output. 28/

64. Both developed and developing host countries are using incentives and disincentives to attract FDI and to internalize the benefits resulting from such investment. Survey studies indicate that developed countries frequently use market access, tariff escalation and investment incentives (often in the form of general corporate tax reduction, cash grants or industry-wide schemes

to support high-technology sectors) to attract investors, while developing countries rely more on fiscal incentives, debt-equity swaps, and export processing zones. 29/ It is also found that TRIMs occur more frequently in developing countries.

65. The use of incentives has intensified in recent years, as countries compete to attract FDI to such an extent that many observers have qualified this situation as an "investment war". Indeed, a survey on government policies on FDI in 46 countries (of which 20 are developed countries) 30/ found that, over the period 1977-1987, the most frequent changes were related to subsidies and fiscal incentives. There were as many as 58 recorded policy changes, 21 of them in developed countries, which aimed at increasing the after-tax and subsidy profitability of foreign investment. In contrast, the lowest frequency of change was recorded in the performance requirements, as only seven policy changes, including one in a developed country, were adopted in this regard.

66. The crucial question is whether the provision of incentives can influence the location of foreign investment. Survey studies on the role of incentives 31/ suggest that the effectiveness of incentives in inducing foreign investors to invest in host countries has been modest or even marginal. In surveys assessing the importance that decision makers attach to various factors affecting the investment location, other considerations - low labour costs, adequate infrastructure, and proximity to markets - frequently rank well above incentives. The limited effectiveness of incentives may also be explained by the fact that, when countries compete for foreign investment, countries with the same locational attributes often offer more or less the same package of incentives.

67. Some other surveys, 32/ however, point out that, while incentives may not play a key role in influencing the decision of whether or not to undertake an overseas investment, once the decision has been taken to set up production facilities abroad, the choice of FDI location may then take into account the availability of incentives. This appears especially true for "footloose" industries, which can choose among production sites with comparable costs; automotive and food processing industries, in particular, seemed to be somewhat sensitive to incentive measures of host countries.

68. As regards individual incentive measures, there is some evidence that fiscal incentives are important for export-oriented FDI, while tariff protection is important for FDI geared to domestic markets. Debt-equity swaps seem to have played a role in the increase of FDI in some Latin American countries. 33/ Export processing zones, by providing a package of fiscal, financial and tariff concessions, along with good infrastructure and other advantages, have helped to attract FDI in a number of developing countries. 34/

69. Finally, a survey study 35/ attempted to measure the effectiveness of investment-related policies by asking foreign investors to specify their behaviour in the case of a country that had applied actual incentive and disincentive policies but removes its investment policy package, while the investment policy packages of all other countries remain constant. The results of the study indicated that performance requirements had a negligible

impact on the location of investment, but that incentive policies influenced the decision to locate the investment in two-thirds of the cases examined. At the margin, host governments could not reduce their packages to attract foreign firms without losing substantial inward FDI.

70. An overall conclusion that can be drawn from these surveys on incentives is that host countries get trapped in the "prisoner's dilemma", leading to competitive bidding in which all participants are left worse off than if no bidding had taken place. As pointed out by Guisinger: "Incentives may be effective in an asymmetrically perverse way: an increase in incentives may produce no net gain in competitive situations, but unilateral withdrawal may be highly detrimental to a country's inflow of foreign capital". 36/

71. It would, therefore, be beneficial for host countries to arrive at a harmonization of policies in order to reduce unnecessary costs. A first step would be to ensure more transparency on FDI policies. Countries can exchange information about their regulatory regime and other FDI-related policies, as well as the impact of these policies on FDI flows with a view to sharing experiences on the costs and benefits arising from those policies. This would help to improve the host countries' bargaining position vis-à-vis foreign investors. From the perspective of TNCs, increased transparency of investment policies would enable them to make better FDI decisions in an overall improved policy environment for their international activities.

72. The Uruguay Round has tackled the issue of TRIMs 37/ considering them as incompatible with some of the GATT articles. The 1991 draft Final Act contains an illustrative list of TRIMs related to trade in goods which are "inconsistent with Articles III (national treatment) and XI (prohibition of quantitative restrictions) of the GATT". Among the TRIMs included are local content requirements and measures that restrict the volume or value of imports or relate it to the level of exports, including access to foreign exchange. Such measures should be notified and eliminated within two years for developed countries, five years for developing countries, and seven years for least developed countries. Developing countries can temporarily deviate from the provisions contained in the Draft Decision, in cases that are consistent with Article XVIII. 38/ Furthermore, the negotiations agreed to review the list of TRIMs within five years and consider whether it should be complemented by provisions on investment and competition policy.

## Notes

1/ By comparison, during the same period the average annual rate of growth for world exports was 10 per cent. See United Nations, World Investment Report 1993 (forthcoming), New York.

2/ At 1990 prices and exchange rates (using GNP deflators for Development Assistance Committee (DAC) member countries).

3/ Reinvested earnings are a more significant component of FDI flows to developing countries than in the developed countries where cross-border flows tend to be more important. Ibid.

4/ Excluding flows to offshore centres.

5/ Partly accounted for by the success of debt-equity swap programmes. During the period 1985-1989, FDI through debt-equity swaps provided 90 per cent of total FDI in Chile; 59 per cent in Brazil; 30 per cent in Mexico, and 20 per cent in Argentina. See, United Nations, World Investment Report 1992 (ST/CTC/130), United Nations publication, Sales No. E.92.II.A.19), p.26.

6/ The countries or territories forming the group of 10 largest developing economies recipients of FDI fluctuate among the following: Argentina, Brazil, China, Egypt, Hong Kong, Indonesia, Malaysia, Mexico, Nigeria, Republic of Korea, Singapore, Taiwan, Province of China, Thailand and Venezuela (table 3). A second group of rapidly emerging host countries includes: Chile, Colombia, India, Morocco, Pakistan, Philippines, Tunisia and Viet Nam.

7/ This classification of FDI motivations is adapted from Robock, S.H. and K. Simmonds, International Business and Multinational Enterprises (Irwin, Boston, 1989).

8/ The unit cost of indirect expenditures, incurred by research and development, design, marketing, organizational and other indirect inputs can be diminished if these expenditures can be spread over a large volume of sales, either through production in large factories (economies of scale) or production in a large number of small factories (economies of scope). The second type of production has become more frequent recently, as technological progress and new organizational structures entail product differentiation and plant descaling.

9/ In 1990, the 100 largest TNCs (excluding those in banking and finance) accounted for about a third of the total stock of FDI. See World Investment Report 1993, op.cit.

10/ Factors relevant to host countries' locational advantages are discussed in sections III and IV.

11/ See UNIDO, "Foreign direct investment flows to developing countries: Recent trends, major determinants and policy implications", PPD.167, 10 July 1990, pp. 15-19.

12/ See Plummer, M. and E. Ramstetter, "Motives and policies affecting U.S. direct investment in ASEAN", Development and South-South Cooperation, vol. V, No. 9, December 1989.

13/ This case of "software technology parks" is cited by Pierre Jacquemot, La Firme Multinationale: une Introduction Economique (Economica, Paris, 1990), pp. 77-78.

14/ A vast literature on global strategies of TNCs treats this topic in detail. See, in particular, M. Porter, The Competitive Advantage of Nations (New York, Free Press, 1990), pp. 55-67 and pp. 606-615; Robock, S.H. and Simmonds, K., op. cit.

15/ For an analysis of the new industrial pattern and its implications, see: Raphael Kaplinsky, "Direct foreign investment in third world manufacturing: Is the future an extension of the past?", IDS Bulletin, vol. 22, No. 2, 1991.

16/ See "The global firm: R.I.P.", The Economist, 6 February 1993.

17/ Examples of relocation of production units in developed countries are cited by Pierre Jacquemot, op. cit., footnote 1, p. 264. According to this source of information, in 1985, Philips decided to relocate the production of television frames from South-East Asia to Europe and the United States, and RCA repatriated assembly lines from Taiwan, Province of China, to the United States. Likewise, in recent years, IBM produced computer parts in integrated production units in the United States, stopping production in Asia. Apple decided to produce its new generation of computers in California, near to its suppliers.

18/ This four-stage development pattern has been developed by M. Porter on the basis of development experiences of developed and developing countries. See M. Porter, op. cit., part III, chap. 10: The competitive development of national economies, pp. 543-576.

19/ Dunning has suggested a similar development cycle to explain the types of FDI that countries attract in line with their stages of development. See John H. Dunning, Explaining International Production (London, Boston, Massachusetts, Hayman, 1988), chap. 5: "The investment development cycle and third world multinationals", pp. 140-168. T. Ozawa has also adopted this development cycle pattern of FDI, based on Porter's analysis of the four stages of development; see Terutomo Ozawa, "Foreign direct investment and economic development", in United Nations, Transnational Corporations, vol. 1, No. 1, New York, February 1992.

20/ See, in particular, J.H. Dunning, op. cit., chap. 5; S. Lall, "Direct investment in South East Asia by the NIEs: Trends and prospects", Banca Nazionale del Lavoro, Quarterly Review, No. 179, December 1991.

21/ Empirical studies on FDI have shown the high correlation between FDI flows and the size and growth of host economies. See, for example, Thomas L. Brewer, "Foreign direct investment in developing countries: Patterns, policies and prospects", World Bank (International Economic Department, Working Paper WPS 712, June 1991); United Nations Centre for Transnational Corporations, "Government policies and foreign direct investment" (ST/CTC/SER.A/17, November 1991).

22/ See World Investment Report 1992, op.cit., p.86.

23/ UNIDO, "Foreign direct investment flows ...", op.cit., p.34.

24/ For an assessment of export processing zones, see UNCTAD, "Export processing zones: Role of foreign direct investment and developmental impact", report by the UNCTAD secretariat (TD/B/WG.1/6), 1993.

25/ For more details on liberalization patterns, see World Investment Report 1992, op.cit., pp. 79-85, and the forthcoming World Investment Report 1993.

26/ See World Investment Report 1992, op.cit., p.77-79.

27/ World Bank, Legal Framework for the Treatment of Foreign Investment, Volume II: Guidelines, 1992.

28/ It is empirically found that imperfect competition is the most accurate characterization of the industries in which FDI takes place; see United Nations: The Impact of Trade-Related Investment Measures on Trade and Development, United Nations publication, Sales No. E.91.II.A.19, New York, 1991.

29/ See OECD: Investment incentives and disincentives: effects on international direct investment (Paris, 1989); United Nations, The Impact of Trade-Related Investment Measures ..., op.cit.; Stephen Guisinger, "Host-country policies to attract and control foreign investment", in Theodore H. Moran and contributors, Investing in Development: New Roles for Private Capital? (Overseas Development Council, Washington D.C., 1986).

30/ UNCTC, "Government policies and foreign direct investment", op.cit.

31/ An account of these survey studies can be found in United Nations, The Determinants of Foreign Direct Investment (United Nations publication, Sales No. E.92.II.A.2, 1992; United Nations, The impact of Trade-Related Investment Measures; S. Guisinger, "Host-country policies to attract and control foreign direct investment", op.cit.; S. Guisinger, "Rhetoric and reality in international business: a note on the effectiveness of incentives", in United Nations, Transnational Corporations, vol.1, No.2, New York, August 1992.

32/ See, for example: D.J.C. Forsyth, US Investment in Scotland (New York, Praeger Publishers, 1972); G.L. Reuber with H. Crookell, M. Emerson and G. Gallais Hamonno, Private Foreign Investment in Development (Oxford, Clarendon Press, 1973).

33/ Empirical studies conducted by IFC and the Institute of International Finance, have concluded that debt-equity swap programmes have induced additional FDI in Latin America. See, J. Bergsman and W. Edisis, Debt-Equity Swaps and Foreign Direct Investment in Latin America, IFC Discussion Paper No. 2, Washington, D.C., 1988; Institute of International Finance: Fostering Foreign Direct Investment in Latin America, Washington, D.C., 1990.

34/ See UNCTAD, "Export Processing Zones ...", op. cit.

35/ Stephen E. Guisinger and associates, Investment Incentives and Performance Requirements (New York, Praeger Publishers, 1985), study sponsored by the IFC of the World Bank.

36/ Stephen Guisinger, "Host-country policies ...", op.cit., p.166.

37/ A decision on TRIMs was included in the draft Final Act of the Uruguay Round. See World Investment Report 1992, op.cit., pp. 70-73.

38/ That is, in cases where the application of TRIMS is necessary owing to balance-of-payments problems and infant industry and development considerations.

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